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*Puerto Rico Farm Credit, ACA*  
***SECOND QUARTER 2002***

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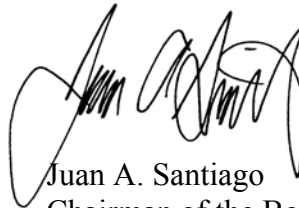
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William A. Garrahan  
Chief Executive Officer



Juan A. Santiago  
Chairman of the Board

July 29, 2002

# Management's Discussion and Analysis of Financial Condition and Results of Operations

*(dollars in thousands)*

The following commentary reviews the consolidated financial condition and results of operations of Puerto Rico Farm Credit, ACA (Association) for the six months ended June 30, 2002. These comments should be read in conjunction with the accompanying consolidated financial statements, notes to the consolidated financial statements and the 2001 annual report of the Association.

## **LOAN PORTFOLIO**

The Association provides funds to farmers, rural homeowners and farm-related business for financing short and intermediate-term loans and long-term real estate mortgage loans. The Association also maintains a portfolio of purchased syndicated loans, originated by other Farm Credit System entities and non-system entities. The Association's predominant local service area (LSA) agricultural commodities were dairy, livestock and fruits which totaled approximately \$101 million or 54 percent of all outstanding loan volume at June 30, 2002.

The gross loan volume of the Association at June 30, 2002 was \$182,448, an increase of \$9,405 or 5.4 percent when compared to \$173,043 at December 31, 2001. Net loans outstanding at June 30, 2002 also increased, but by \$9,578, or 5.8 percent, primarily as a result of a \$174 reduction in the allowance for loan losses during the first quarter of 2002. The improvement in gross loan volume was primarily related to material increases in the fruits, ornamentals and rural home loan industries. Smaller positive changes occurred in the livestock, plantain and participations purchased.

Net loans at June 30, 2002 made up 95.9 percent of total assets, compared to 95.6 percent at December 31, 2001. At June 30, 2001 the percentage was 94.7 percent. The increase during the past twelve months reflected the \$17,851 increase in net loan volume and reductions in all other categories of assets.

As a percentage of gross loans, nonaccrual loans equaled 2.4 percent, compared with 2.5 percent and 3.8 percent at December 31, 2001 and June 30, 2001, respectively. The decrease in the percentage was primarily the result of a partial payment received from the sale of collateral property related to a large volume account during the second half of 2001. Due to the substantial increase in loan volume, the overall credit quality of the total portfolio continued to show improvement. Credit quality has also been supported and enhanced by the lower interest rate environment, favorable weather and stable product demand.

The Association maintained an allowance for loan losses in an amount considered by management as sufficient to absorb the estimated risk inherent in the loan portfolio. The allowance for loan losses decreased from \$6,674 at December 31, 2001 to \$6,501 at June 30, 2002. The reduction of \$173 reflected management's updated analysis of the risk of loss in the portfolio. The analysis identified less risk as a result of a lower level of nonaccrual loans and improved credit quality. The ratio of allowance to gross loan volume was 3.6 percent at June 30, 2002 and 3.9 percent at December 31, 2001. There were no charge-offs during the first two quarters of 2002, while recoveries totaled less than \$1.

## **RESULTS OF OPERATIONS**

Net income for the six months ended June 30, 2002 totaled \$1,379, a decrease of \$540 or 28.1 percent compared to the same six-month period of 2001. Despite higher levels of accruing loan volume, from both LSA and participation operations, the significantly lower interest rate environment resulted in a reduction of \$985 in net interest income. This was partially offset by a positive increase in other operational areas of \$445.

Net interest income at June 30, 2002 was \$3,012 a decrease of \$985 or 24.6 percent from June 30, 2001 when net interest income was \$3,997. This decrease was primarily related to the lower interest rate environment, which resulted in a reduction of \$780 in interest expense credits earned from AgFirst Farm Credit Bank (the Bank). For the six months ended June 30, 2002 interest credits earned were \$365 compared to the first six months of 2001 when interest credits totaled \$1,145, a decrease of 68 percent. Additionally, during the first six months of 2002 interest income recognized from the collection of nonaccrual loans decreased by \$128 when compared to the first six months of 2001. Management continues to project lower levels of net interest income, as the most likely scenario for the balance of 2002 has the interest rate environment remaining at historically low levels.

During the first quarter of 2002, a decision by management to reduce the allowance for loan losses resulted in a \$174 reversal of provision which enhanced income. There was no change that resulted in a provision in the allowance for loan losses during the second quarter. Noninterest income for the first six months of 2002 totaled \$115 compared to \$148 for the first six months of 2001. Primarily this was the result of decreased fee income from the recognition of prepayment penalties related to rural housing loans and late charge penalties from installments paid after the due date.

Noninterest expense for the six months ended June 30, 2002 was \$1,902 as compared to \$2,347 at June 30, 2001. The decrease was primarily related to the absence of \$536 in restructuring expense incurred during the first six months of 2001. Otherwise, noninterest expenses increased by \$91 in 2002 versus 2001, primarily due to increases in employee benefits, Farm Credit System Insurance Corporation premium payments and guarantee fees paid to the Bank.

During the first quarter of 2002, the Association incurred federal tax expense of \$21, \$15 related to the first quarter's estimated tax provision and \$6 related to the filing of the 2001 federal tax return. During the second quarter the Association recognized no estimated federal income tax expense and made an adjusting entry for \$1. This compared to the first six months of 2001 when the Association recognized a net tax benefit of \$121, mostly as a result of recording a prior period adjustment for \$153. The adjustment, which enhanced net income, was recorded upon signing a closing agreement with the IRS related to an amended 1999 federal tax return.

Management projects that 2002's federal income tax expense will also be an enhancement to final net income, similar to 2001. During the third quarter of 2002, the Association expects to sign a closing agreement with the IRS related to an amended 2000 federal tax return. When the agreement is signed the Association will recognize a prior period adjustment for \$193. Additionally, as management refines the holding company structure established during 2001, it is projected that the resultant federal tax liability and related provision expense for 2002 will be zero.

**For the three months ended June 30, 2002.**

Net income for the second quarter of 2002 was \$567 compared to \$1,057 for the second quarter of 2001. The primary factor in the decrease totaling \$490 was a decline in net interest income of \$507. The same as for the year-to-date, the lower interest rate environment negatively impacted the interest credit earned from the Bank.

Noninterest income decreased by \$21 during the second quarter. Noninterest expense for the three months ended June 30, 2002 totaled \$965 a decrease of \$26 from the second quarter of 2001. The decrease was primarily related to the absence of restructuring charges, which more than offset increased expenses in other categories.

During the second quarter of 2002 the Association recorded no provision for federal income tax. The \$1 benefit resulted from an auditing adjustment for prior year deferred tax activity.

**Key Results of Operations Ratios:**

	<b>Annualized for the six months ended 6/30/02</b>	<b>For the year ended 12/31/01</b>
Return on Average Assets	1.54%	2.18%
Return on Average Stockholders' Equity	6.07%	8.28%
Net Interest Income as a Percentage of Average Earning Assets	3.46%	4.56%

**LIQUIDITY AND FUNDING SOURCES**

*Liquidity*

Liquidity management is the process whereby funds are made available to meet all financial commitments including the extension of credit, payment of operating expenses and payment of debt obligations. The Association receives access to funds through its borrowing relationship with the Bank and from income generated by operations. Sufficient liquid funds have been available to meet all financial obligations.

*Funding Sources*

The principal source of funds for the Association is the borrowing relationship established with the Bank through a General Financing Agreement. The General Financing Agreement utilizes the Association's credit and fiscal performance as criteria for establishing a line of credit on which the Association may draw funds. The funds are advanced by the Bank to the Association in the form of notes payable. The notes payable are segmented into variable rate and fixed rate sections. The variable rate notes are utilized by the Association to fund variable rate loan advances and operating funds requirements. The total notes payable to the Bank at June 30, 2002 was \$135,836 as compared with \$126,564 at December 31, 2001. The increase of \$9,272 or 7.3 percent very closely corresponded to the \$9,405 increase in gross loan volume during the first half of 2002.

The Association had no lines of credit outstanding with third parties as of June 30, 2002.

*Funds Management*

Demand for loan types is a driving force in establishing a funds management strategy. The Association offers variable rate loan products which are competitively priced according to financial market rates. Variable rate loans may be indexed to either the Prime rate or the 90-day London Interbank Offered Rate (LIBOR). The majority of the interest rate risk in the Association balance sheet is transferred to the Bank through the notes payable structure. The Bank, in turn, actively utilizes funds management techniques to identify, quantify and control interest rate risk associated with the loan portfolio.

**CAPITAL RESOURCES**

Total stockholders' equity at June 30, 2002 increased 2.9 percent to \$45,981 from December 31, 2001 when total stockholders' equity was \$44,686. The increase was attributable to net income retained as unallocated surplus during the quarter.

Total capital stock and participation certificates were \$994 on June 30, 2002 compared to \$974 on December 31, 2001. The net increase of \$20 was the result of new customers purchasing more stock than was refunded to borrowers who paid their loans in full.

Retained earnings unallocated increased \$1,275 or 2.9 percent from December 31, 2001 when unallocated retained earnings totaled \$43,712. The increase was net income in excess of equity dividends declared. The Association's directors declared cash dividends for the thirty-sixth consecutive quarter. The table below sets forth the amount of dividends declared:

<b>Quarter</b>	<b>Equity Based</b>	<b>Patronage Based</b>
Second 2002	\$50	
First 2002	\$49	
Fourth 2001		\$1,238
Third 2001	\$49	
Second 2001	\$49	
First 2001	\$50	
Fourth 2000		\$1,102

The Board of Directors intends to continue its policy of declaring quarterly cash dividends. However, the fourth quarter's dividend will be based on client patronage, rather than equity ownership. The amount of dividends, as always, will depend on continued strong earnings, the overall financial condition of the Association and other factors.

The Association's regulatory permanent capital ratio at June 30, 2002 was 27.63 percent compared to 28.98 percent at December 31, 2001. The decrease in the ratio reflected an increase in weighted average assets during the first six months, as a result of higher gross loan volume. The Association's total surplus and core surplus ratios were both 26.96 percent at June 30, 2002. All three ratios were well above the minimum regulatory ratios of 7.00 percent for permanent capital and total surplus ratios and 3.50 percent for the core surplus ratio.

**Key financial condition ratios were as follows:**

	<b>6/30/02</b>	<b>12/31/01</b>
Stockholders' Equity to Assets	25.05%	25.69%
Debt to Stockholders' Equity	2.99:1	2.89:1

**IRS TAX SETTLEMENT**

As previously disclosed in the 2000 Annual Report and updated in the 2001 Annual Report, Farm Credit System ACAs entered into a settlement process with the IRS to resolve conclusively the status of all claimed refunds and the ongoing tax status of the ACAs using another ACA as a model. In August 2000, the model ACA reached a settlement agreement with the IRS resolving the taxability of the prior years' earnings from its long-term mortgage lending activities and provided for 60 percent of the refund claimed to be returned to the ACA, plus interest for the applicable periods.

During the second quarter of 2001, the Association submitted to the IRS an amended 2000 federal tax return. Management expects to receive a signed agreement from the IRS during the second half of 2002. Thus, like 2001, the 2002 financial statements are projected to reflect a net federal tax benefit enhancing net income by approximately \$193.

*Puerto Rico Farm Credit, ACA*  
**Consolidated Balance Sheets**

<i>(dollars in thousands)</i>	<b>2002</b>	<b>June 30, 2001</b>	<b>December 31, 2001</b>
	<i>(unaudited)</i>		
<b>Assets</b>			
Cash	\$ 9	\$ 18	\$ 37
Loans	182,448	164,776	173,043
Less: allowance for loan losses	6,501	6,680	6,674
Net loans	175,947	158,096	166,369
Accrued interest receivable	1,008	1,500	1,026
Investment in AgFirst Farm Credit Bank	4,712	5,236	4,712
Premises and equipment, net	783	877	808
Other property owned	—	21	10
Other assets	1,085	1,204	1,005
Total assets	<u>\$ 183,544</u>	<u>\$ 166,952</u>	<u>\$ 173,967</u>
<b>Liabilities</b>			
Notes payable to AgFirst Farm Credit Bank	\$ 135,836	\$ 120,862	\$ 126,564
Accrued interest payable	189	370	154
Dividends payable	50	50	1,233
Other liabilities	1,488	1,449	1,330
Total liabilities	<u>137,563</u>	<u>122,731</u>	<u>129,281</u>
Commitments and contingencies			
<b>Stockholders' Equity</b>			
Capital stock and participation certificates	994	980	974
Retained earnings			
Unallocated	44,987	43,241	43,712
Total stockholders' equity	<u>45,981</u>	<u>44,221</u>	<u>44,686</u>
Total liabilities and stockholders' equity	<u>\$ 183,544</u>	<u>\$ 166,952</u>	<u>\$ 173,967</u>

*The accompanying notes are an integral part of these financial statements.*

*Puerto Rico Farm Credit, ACA*  
**Consolidated Statements of Income**  
*(unaudited)*

<i>(dollars in thousands)</i>	<b>For the three months ended June 30,</b>		<b>For the six months ended June 30,</b>	
	<b>2002</b>	<b>2001</b>	<b>2002</b>	<b>2001</b>
<b>Interest Income</b>				
Investment securities	\$ —	\$ 1	\$ —	\$ 1
Loans	2,053	3,251	4,121	6,863
Total interest income	2,053	3,252	4,121	6,864
<b>Interest Expense</b>				
Notes payable to AgFirst Farm Credit Bank	571	1,263	1,109	2,867
Net interest income	1,482	1,989	3,012	3,997
Provision for (reversal of) loan losses	—	—	(174)	—
Net interest income after provision for (reversal of) loan losses	1,482	1,989	3,186	3,997
<b>Noninterest Income</b>				
Loan fees	44	54	85	110
Fees for financially related services	4	4	7	7
Miscellaneous	1	12	23	31
Total noninterest income	49	70	115	148
<b>Noninterest Expense</b>				
Salaries and employee benefits	623	532	1,262	1,133
Occupancy and equipment	58	46	111	117
Insurance Fund premium	16	—	31	3
Guarantee fee	45	35	90	72
Other operating expenses	223	269	408	477
Restructuring charges	—	101	—	536
Losses on other property owned, net	—	8	—	9
Total noninterest expense	965	991	1,902	2,347
Income before income taxes	566	1,068	1,399	1,798
Provision (benefit) for income taxes	(1)	11	20	(121)
Net income	\$ 567	\$ 1,057	\$ 1,379	\$ 1,919

*The accompanying notes are an integral part of these financial statements.*

*Puerto Rico Farm Credit, ACA*

## Consolidated Statements of Changes in Stockholders' Equity

*(unaudited)*

<i>(dollars in thousands)</i>	<b>Capital Stock and Participation Certificates</b>	<b>Retained Earnings Unallocated</b>	<b>Total Stockholders' Equity</b>
Balance at December 31, 2000	\$ 1,012	\$ 41,421	\$ 42,433
Net income		1,919	1,919
Capital stock/participation certificates issued	32		32
Capital stock/participation certificates retired	(64)		(64)
Cash dividends declared		(99)	(99)
Balance at June 30, 2001	<u>\$ 980</u>	<u>\$ 43,241</u>	<u>\$ 44,221</u>
Balance at December 31, 2001	\$ 974	\$ 43,712	\$ 44,686
Net income		1,379	1,379
Capital stock/participation certificates issued	63		63
Capital stock/participation certificates retired	(43)		(43)
Cash dividends declared		(99)	(99)
Dividend adjustment		(5)	(5)
Balance at June 30, 2002	<u>\$ 994</u>	<u>\$ 44,987</u>	<u>\$ 45,981</u>

*The accompanying notes are an integral part of these financial statements.*

*Puerto Rico Farm Credit, ACA*

# Notes to the Consolidated Financial Statements

*(dollars in thousands, except as noted)  
(unaudited)*

## **NOTE 1 — ORGANIZATION AND SIGNIFICANT ACCOUNTING POLICIES**

A description of the organization and operations of Puerto Rico Farm Credit, ACA (the Association), the significant accounting policies followed, and the financial condition and results of operations as of and for the year ended December 31, 2001, are contained in the 2001 Annual Report to Stockholders. These unaudited second quarter 2002 consolidated financial statements should be read in conjunction with the 2001 Annual Report to Stockholders.

As disclosed in the 2001 Annual Report, pursuant to a plan of restructuring approved by the Farm Credit Administration and Association shareholders, the Association reorganized its corporate structure effective July 1, 2001. Pursuant to this restructuring, a Federal Land Credit Association (FLCA) and Production Credit Association (PCA) were formed as wholly owned subsidiaries of the Association. The formation of these subsidiaries enables the Association to take advantage of the tax-exempt status of long-term mortgage interest for loans owned or participated by the FLCA. This restructuring was accounted for as a reorganization of entities under common control similar to a pooling of interests.

As a result of the restructuring, long-term lending activity has been participated into a wholly owned FLCA subsidiary, which is exempt from federal income tax. The ACA, which is the holding company, will continue to be subject to federal income tax.

The accompanying consolidated financial statements contain all adjustments necessary for a fair presentation of the interim financial condition and results of operations and conform with generally accepted accounting principles. The results for the six months ended June 30, 2002, are not necessarily indicative of the results to be expected for the year ending December 31, 2002.

Certain amounts in prior period consolidated financial statements have been reclassified to conform to current consolidated financial statement presentation. Such reclassifications had no effect on the prior period net income or total capital as previously reported.

The Association maintains an allowance for loan losses in accordance with generally accepted accounting principles. The loan portfolio is reviewed quarterly to determine the adequacy of the allowance for losses. As of June 30, 2002, the allowance for losses is adequate in management's opinion to provide for possible losses on existing loans.

## **NOTE 2 — ALLOWANCE FOR LOAN LOSSES**

An analysis of the allowance for loan losses follows:

Balance at 12-31-00	\$6,680
(Reversal of) provision for loan losses	—
Recoveries, net of loans charged off	—
Balance at 6-30-01	<u>\$6,680</u>
Balance at 12-31-01	\$6,674
(Reversal of) provision for loan losses	(174)
Recoveries, net of loans charged off	<u>1</u>
Balance at 6-30-02	<u>\$6,501</u>

## **NOTE 3 — COMMITMENTS AND CONTINGENT LIABILITIES**

Actions are pending against the Association in which money damages are sought. However, on the basis of information now at hand, management and legal counsel are of the opinion that the ultimate liability, if any, resulting therefrom, would not be material in relation to the overall financial position of the Association.